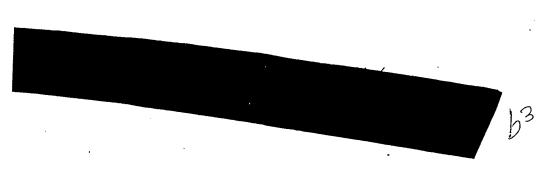
Directorate of Intelligence



Near East and South Asia Review 3



9 March 1990

Approved for Release Date JUN 1999

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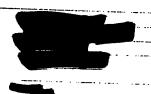
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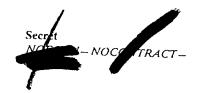
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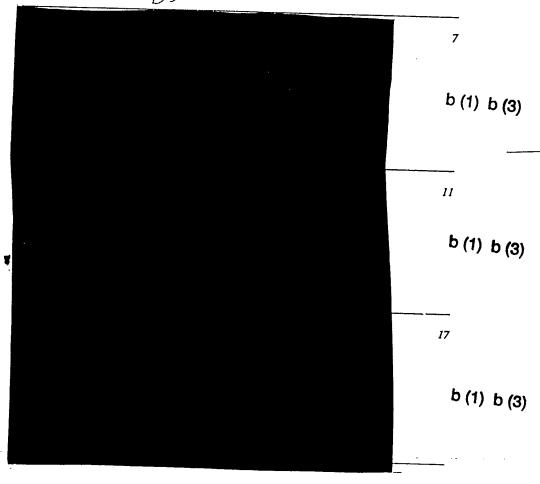


Near East and South Asia Review

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Articles Arab World: Impact of Changes in the Soviet Union and Eastern
Europe 17

The dramatic developments in the Soviet Union and Eastern Europe have raised new concerns and expectations in the Arab world. States with close ties to the East are facing reduced political, economic, and military support, while states with close ties to the West fear resources will be diverted to Eastern Europe and the US commitment to the Arab world will drop.



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Syria: Achieving Defensive Parity 25 The Syrian armed forces have achieved defensive strategic parity with Israel, but the Syrian military still has many weakness that would make sustaining prolonged defensive operations difficult. Lebanon: Who Murdered President Muawad? 31 President Muawad was killed by a ground-level explosion of hundreds of kilograms of plastic explosive. Lebanese Christian strongman Michel Awn was most likely responsible for Muawad's death, and he may have been aided by the Palestine Liberation Organization or the Iraqi Government. Libya's Deteriorating Economy: Contributing to Domestic Unrest? Libyan leader Qadhafi has abandoned the economic reform program he launched in 1988 and appears to be setting the stage for a new round of economic austerity measures. The country's foreign payments situation is deteriorating, inflation is on the rise, and the banking sector has been hit hard by capital flight. Kuwait-Egypt: Maturing Bilateral Ties 39 Kuwait's interest is securing Egyptian stability and its apparent belief that Cairo will once again become a strong moderating force in the Arab world provide the foundation for increasingly close Kuwaiti Egyptian ties.

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Near East and South Asia Review

Articles

Arab World: Impact of Changes in the Soviet Union and Eastern Europe

The dramatic developments in the Soviet Union and Eastern Europe have raised new concerns and expectations in the Arab world. Authoritarian rulers, particularly Syria's President Assad and Iraq's President Saddam Husayn, fear popular pressure for change may spread to their countries. States with close ties to the USSR and Eastern Europe such as Syria, Libya, and Algeria are facing reduced political, economic, and military support. Moderate Arab states with close ties to the West, such as Egypt and Saudi Arabia, are concerned that Western economic resources will be diverted to Eastern Europe and that the relaxation in East-West tensions will reduce the US commitment to them and to the Arab-Israeli peace process. There are several potentially favorable implications for the United States if current trends are sustained, particularly the declining danger of confrontation with the Soviet Union and the increasing prospect of cooperation with Moscow on regional issues of importance

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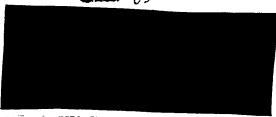
Soviet-East European New Thinking and the Arab World

Since coming to power in 1985, Soviet President Gorbachev has made clear that restructuring within the Soviet Union is his primary goal and that he needs a more relaxed international environment to accomplish this. His new approach to the Arab world is evident in such policy changes as increased flexibility with respect to virtually all aspects of the Arab-Israeli peace process, expanded contacts with Israel, increased identification with the objectives and interests of moderate Arabs, warnings to radical Arab clients that military solutions to regional disputes are not feasible, and a willingness to cooperate with the United States to resolve regional tensions.

The new governments of Eastern Europe have not had much time to reevaluate their policies toward the Arab world, but they are accelerating the pace of policy revisions begun by their predecessors. The expansion of East European relations with Israel has intensified in recent months as Hungary, Czechoslovakia, and Poland have established diplomatic relations with Tel Aviv.

Arab Responses to Soviet and East European **Policy Changes**

Pro-Soviet Arabs. Arab officials who have had close ties to the Communist states are almost certainly concerned that the USSR and Eastern Europe are becoming less committed to the Arab cause. The Syrian perception of a declining Soviet commitment already has led to modifications in policy such as Syria's decision to strengthen its regional position by reestablishing inlomatic relations with Egypt. Other Arab states with close ties to Moscow also have taken steps to bolster their regional positions. Libya has improved its ties to Egypt and sought closer relations with its Maghreb neighbors, and South Yemen has moved toward unification with North Yemen.



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The Challenge of Economic Change in Eastern Europe and the Soviet Union

Rapid economic change in Eastern Europe and the Soviet Union will challenge Middle Eastern governments to speed up sluggish economic reform efforts because they face increased competition for foreign aid, investment, loans, and markets. The hurden of change will fall largely on resource-poor states that depend on external assistance. We expect them to push for stronger regional economic cooperation agreements and to seek increased trade, aid, and investment ties to Japan, so-called newly industrializing countries, and the United States. More vigorous reform programs in the Middle East are likely to spread economic opportunities more broadly and possibly move Arab states toward greater political liberalization.

During the 1980s most countries in the region borrowed heavily to meet development needs and compensate for declining oil revenues and aid flows. The growing debt burden forced several countries, including Iraq, Israel, Egypt, Morocco, and Algeria, to embark on programs to streamline public-sector enterprises, diversify and promote exports, and increase economic efficiency. The success of these reform programs depends, in part, on the availability of external financing and eased access to Western markets.

The massive financing requirements of economic restructuring in Eastern Europe and the Soviet Union threaten to squeeze Middle Eastern countries that are banking on external funds to help underwrite their economic reform efforts. Israel and Egypt, major recipients of US security and economic assistance, have begun lobbying hard to maintain and even increase current aid levels. International Monetary Fund and World Bank borrowers such as Jordan, Egypt, and Algeria fear that proposed lending to Eastern Europe or the Soviet Union will limit the availability of concessional credit.. Many Middle Eastem countries are also major commercial borrowers and are likely to face harder terms - higher interest rates and shorter repayment schedules - as they compete with Eastern Europe and possibly the Soviet Union for loans. \$3

Restrictive policies have limited foreign investment in many Middle Eastern countries, and changes in Eastern Europe and the Soviet Union will make the task of attracting investors more difficult. Foreign investors have been denied access to lucrative petroleum industry operations, and bureaucratic impediments in several countries severely limit private-sector activity. Unless current investment

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Moderate Arabs. Those Arab states with close ties to the United States and Western Europe are concerned that Western political and economic resources will be diverted to Eastern Europe.

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Possible Outbreak of Revolution in the Arab World

Comparison of Arab and East European Regimes. The strength and effectiveness of popular unrest in Eastern Europe have caused considerable Arab anxiety that prodemocracy sentiments will spread to the Middle East. There are several similarities between the former regimes in Eastern Europe and some Arab regimes:

 The legitimacy of some Arab regimes is as questionable as the legitimacy of Eastern Europe's Communist governments. Minority faction slacking historical or popular credibility

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policies are liberalized, the region will be hard pressed to compete with Eastern Europe's low-cost, skilled work force, proximity to the expanding West European market, and longstanding cultural ties to the West

Trade prospects for Middle Eastern countries are likely to be mixed as a result of economic reforms in Eastern Europe and the Soviet Union. In the short run, oil exporters such as Iraq and Iran that are willing to negotiate countertrade arrangements—probably linked to arm sales—are likely to expand trade with foreign exchange-constrained Eastern Europe and the Soviet Union. High-technology exporters such as Israel may well find new markets for their products, and technology importers such as Iraq are likely to benefit from a loosening of Western export controls to Eastern Europe and the Soviet Union.

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Over time, the Middle East will face increased competition from East European and Soviet goods in world markets. Low-cost East European products are likely to compete directly with Middle Eastern textile and light engineering exports throughout Europe—the largest market for most Middle Eastern exporters. The integration of the European

community in 1992 has already fueled fears among Middle Eastern producers that their products will face increased trade barriers.

Economic reform in Eastern Europe and the Soviet Union will also upset longstanding trade and aid relationships with several Middle Eastern countries. Indications that Moscow is considering moving toward a convertible currency and is placing its economic relations on a commercial basis threaten to weaken ties to major partners such as Syria. The countries of Eastern Europe have already started reducing aid programs and are considering selling their Middle Eastern loans to finance their economic reform efforts.

To strengthen their bargaining position in the changing global environment, we expect the Middle Eastern countries will try to jumpstart stalled economic cooperation agreements under the aegis of regional organizations such as the Gulf Cooperation Council, the Arab Cooperation Council, and the Arab Maghreb Union. With Western Europe preoccupied with its eastern neighbors, the Middle Eastern states are likely to try to expand economic ties to Washington and Tokyo.

are in power in Syria, Iraq, and South Yemen, for example.

- Totalitarian governments, to some extent patterned on the Soviet and East European model, are entrenched in such Arab states as Iraq and Syria, and they are sustained by hated security forces.
- Corruption is widespread in most Arab governments, as is popular awareness of corruption.
- Many Arab states have serious economic
 problems, and there is a growing disparity between the wealthy and the poor.
- There is a history of mass demonstrations in the streets in several Arab countries, including Egypt, Algeria, Syria, and Iraq.

There are important differences, however, between the situation in Eastern Europe and in the Arab world:

- Arab regimes have depended on their ownmilitary and security services. The Communist regimes imposed on Eastern Europe after World War II were sustained by the demonstrated power of the Soviet military.
- The armed forces in Eastern Europe were reluctant to fire on their own people, facilitating the collapse of the regimes. Although many Arab leaders may be unsure of the ultimate reliability of their military forces, they have not been faced with military refusal to carry out orders.
- Strong religious, tribal, clan, and extended family ties characteristically underpin political

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structures in the Arab world, contributing to the stability of these societies

Arab Concern About the Possible Spread of Revolution. The dramatic events in Eastern Europe have had resonance throughout the Arab world, but the violent overthrow of the Ceausescu regime in Romania in December 1989 was particularly shocking to the autocratic regimes in Syria and Iraq.

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hope to preempt popular pressure against their regimes.

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Saddam Husayn has admitted there were shortcomings in his regime and has promised corrective measures. indicates he has relaxed foreign travel restrictions and increased his public contacts to present the image of a leader who cares for his people.

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Moderate Arab leaders also may face popular pressure for change. The Government of Kuwait has been under pressure to reconvene its parliament, and in January 1990 there were prodemocracy demonstrations in Kuwait.

Bahrainis are urging the ruling family to liberalize, arguing that there are lessons to be learned from Eastern Europe. Jordan recently held a parliamentary election and has created a new forum for criticism of government actions, and Egypt, because of its economic problems and relative political openness, must also be considered vulnerable to popular unrest.

Prospects

The revolutions in Eastern Europe could have a catalytic affect on the Arab world, encouraging disillusioned and disaffected populations and feeding popular demonstrations and protests. This may seem most likely in countries with regimes similar to those toppled in Eastern Europe, but it could occur in any Arab state with a dissatisfied population.

Those Arab leaders who feel particularly vulnerable such as Assad and Saddam Husayn will consider a range of options to preempt challenges to their rule. They may introduce limited reforms to prevent popular pressures, but they are unlikely to permit genuine liberalization that might threaten their regimes. They will not miss a major lesson being provided by the Soviet Union and Eastern Europe - that political concessions stimulate demands for greater concessions and that those governments that have initiated change become increasingly vulnerable. Thus, should real popular challenges develop in Syria or Iraq, Assad and Saddam Husayn almost certainly would reject liberalization and turn to repression to control popular pressures. 63

The more moderate Arab leaders may pursue new policies to preempt or limit popular challenges.

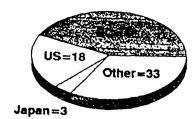
President Mubarak of Egypt, King Hussein of Jordan, and President Ben Ali of Tunisia are among

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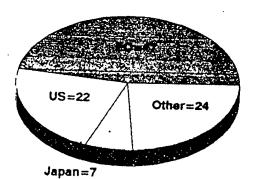
Changing Market Share for Middle Eastern Manufactures

Total = US\$ 14 Billion
Percent Share

Total = US\$7 Billion
Percent Share



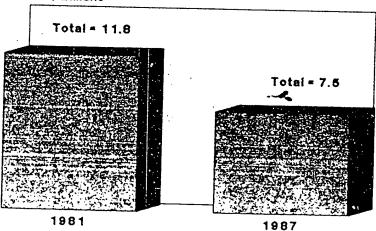
1981



1987

Economic Assistance Flows*

US \$ Billions



* Total net disbursements from all sources

Middle East

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the more likely leaders to emphasize reform. It is unclear how change would develop or what its nature would be. Few Arab leaders are likely to pattern their programs on Western models. They are far more likely to look to their own history and culture and to seek accommodation with the prevalent ideology of change in the region — Islamic fundamentalism. An Islamic model could contain elements of democracy (as in Iran's Consultative Assembly), but it could also contain elements of religious authoritarianism. A system based on fundamentalism is likely to be both anti-Western and anti-Communist in orientation.

Implications for the United States

Continuation of current Soviet and East European policies in the Arab world will have several implications for states in the region as well as for the United States:

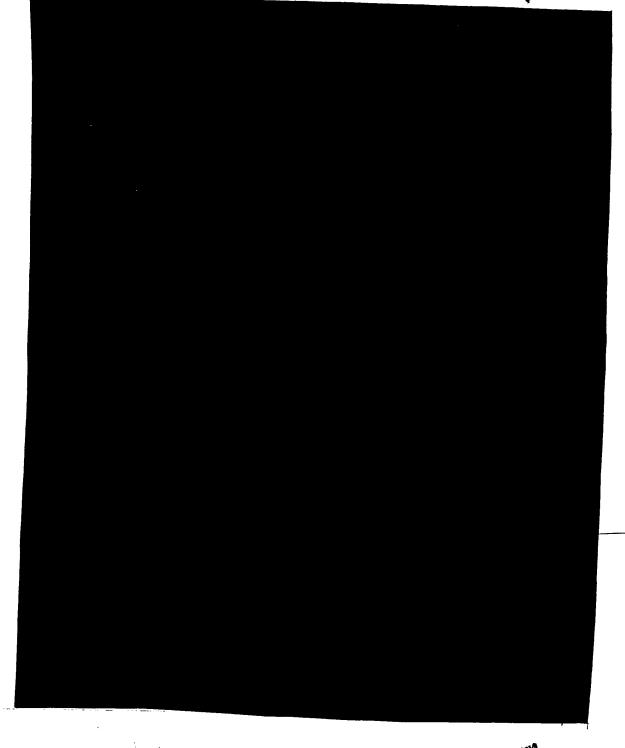
 The danger of direct US-Soviet confrontation in the Arab world will continue to decline.
 Moscow and Washington may be more able to cooperate on regional issues of importance to them, such as preventing missile proliferation.

- Those Arab states that relied on the Soviet Union may reorient their policies and may even adopt more conciliatory positions toward the United States.
- The Arab world will increasingly view the Soviet Union as a legitimate member of the world community. Soviet credibility as a mediator will be enhanced, and the preeminent role of the United States may decline.
- Autocratic regimes seeking to loosen political and economic strictures are likely to seek help from and improved relations with the international community, including the United States. Should they turn to repression, they would face international censure and could become more inward looking and less conciliatory. They could even become more aggressive externally as they seek to distract domestic attention and justify repression.

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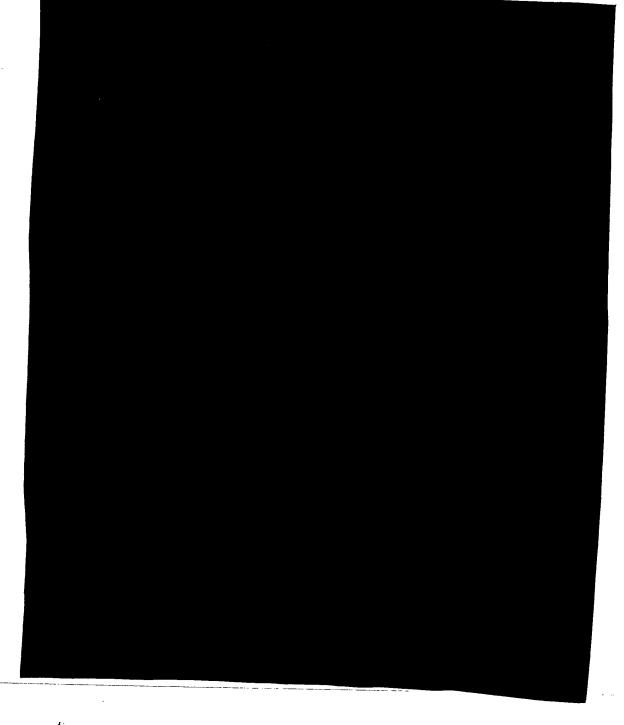
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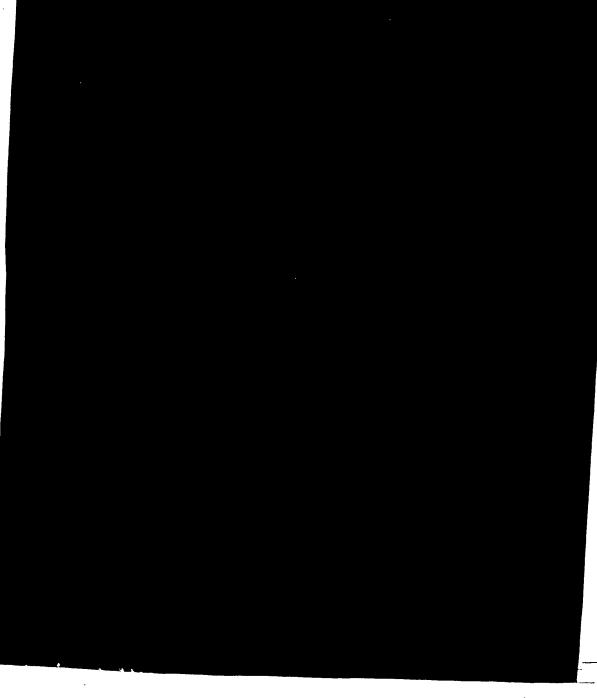


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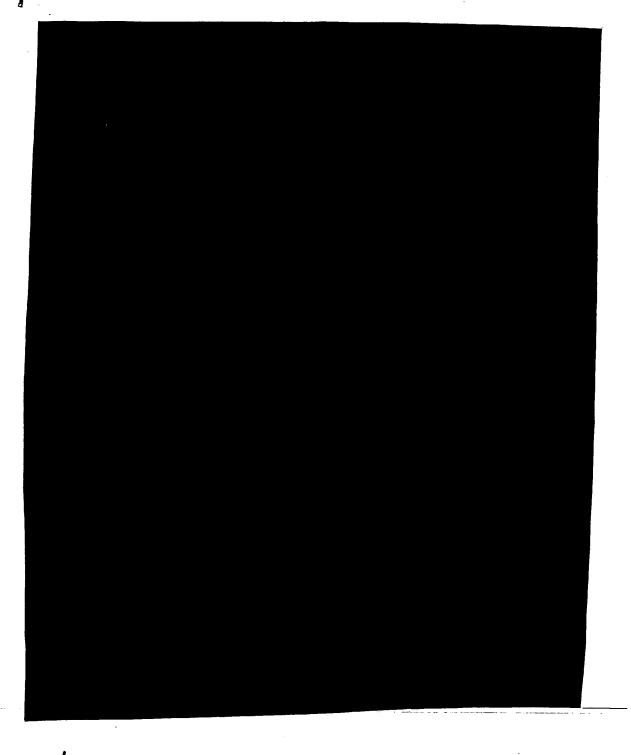


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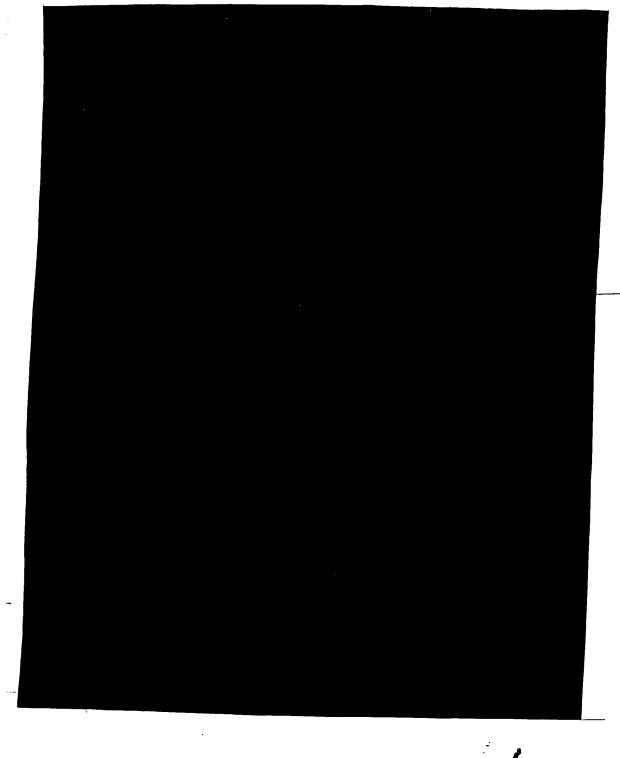
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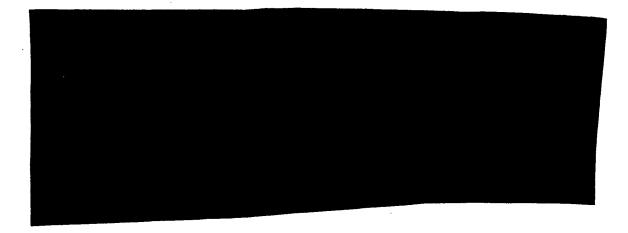
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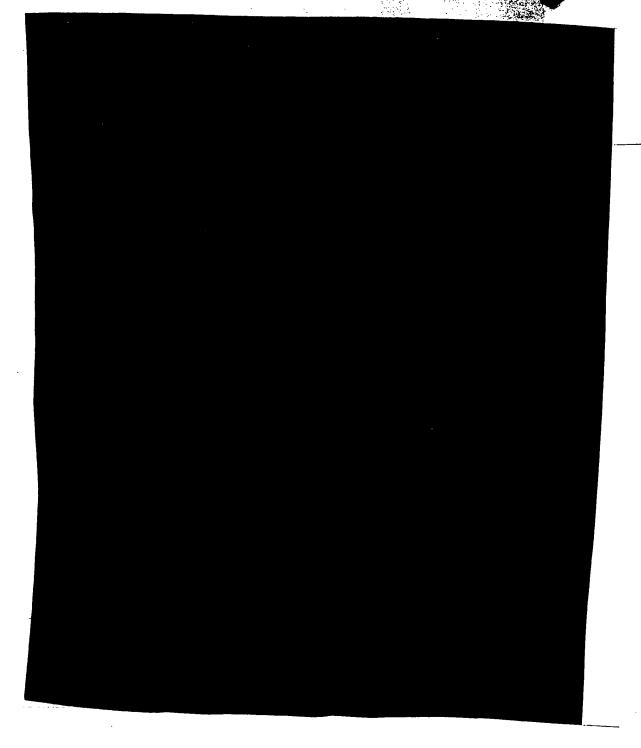
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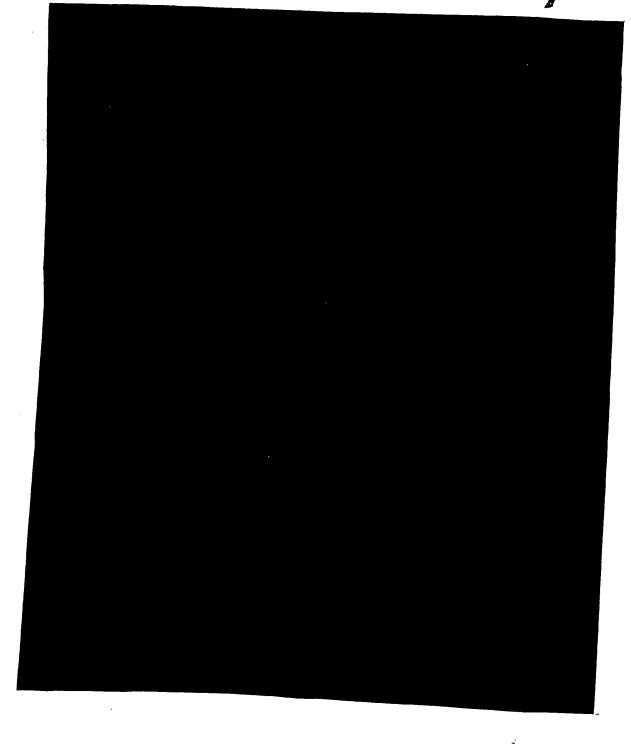
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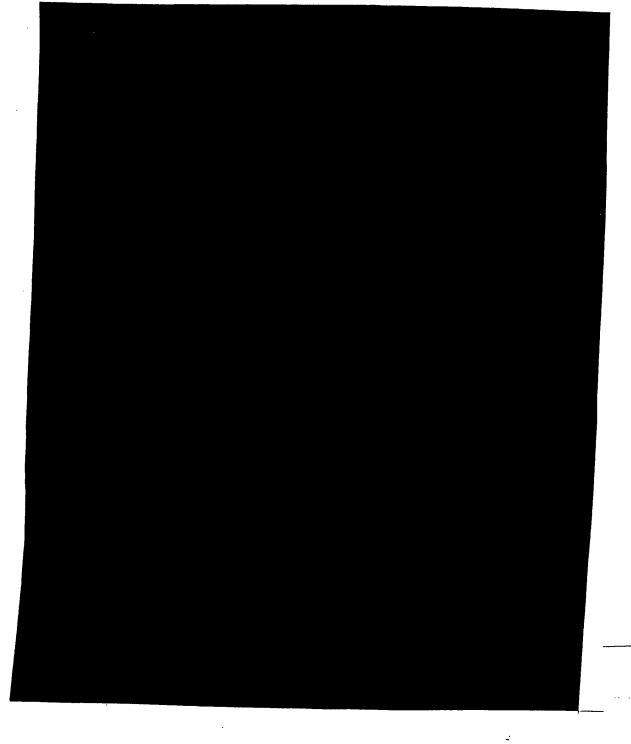
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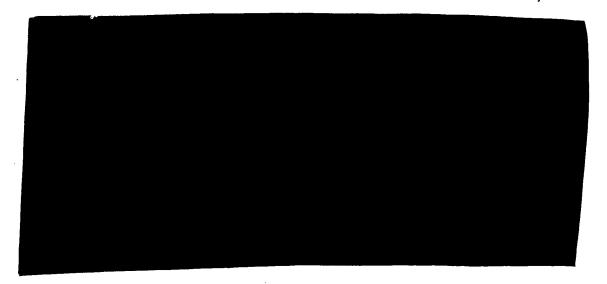
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Syria: Achieving Defensive Parity

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During the past 10 years, Damascus has built a strong conventional force and a deterrent capability based on its chemical warfare program that would make a confrontation with Israel costly for Tel Aviv. The Syrian military still has many weaknesses that would make sustaining prolonged defensive operations difficult. Syria will be hard pressed in the next few years to develop the capability to launch an offensive strike against Israel or to sustain the military gains made over the last decade.

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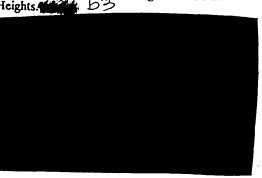
Definitions of Strategic Parity

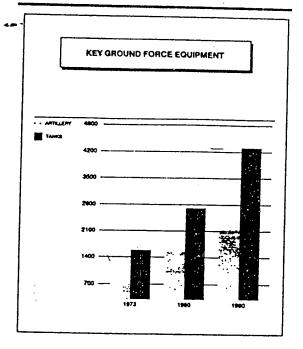
Syrian President Assad defines strategic parity in broad terms encompassing social and economic factors, such as technical and educational capabilities, in addition to the military balance between Syria and Israel,

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the "achievement of a parallel level with the forces of the enemy to deter aggression." He further states that "this does not mean forces should be matched, man for man, rifle for rifle, plane for plane. Rather defense forces should be sufficient to convince the opposite side that efforts at expansion would fail." We believe the principal motivating factor behind Assad's quest for military parity is his view that Syria has to be able to negotiate with Israel from a position of strength, not weakness, if it hopes to regain the Golan Heights.

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The Soviet Role

The Syrians achieved defensive parity largely because of massive Soviet support. The Soviets sought to modernize the Syrian military with massive infusions of sophisticated equipment intended to lessen key Syrian vulnerabilities. The Soviets concentrated on developing Syrian air defenses, electronic warfare, and command, control, and communications capabilities. Under Gorbachev, Moscow has clearly indicated it opposes Assad's concept of offensive strategic

9 March 1990



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parity

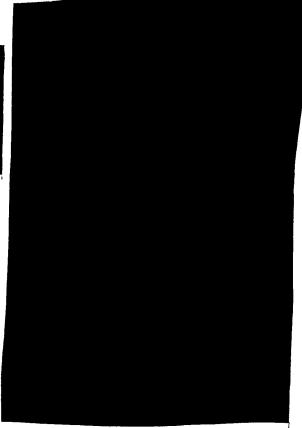
deployment of several surface-to-air missile systems — the tactical SA-8, SA-9, and SA-13 and the strategic SA-5 — strengthened Syrian air defenses.

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Modernizing Conventional Forces

Ground Forces. Modernization of Syrian ground forces has progressed steadily, but it has not significantly closed the technological and qualitative gap with the Israelis.

Moreover, Syrians have deployed their newest tanks to second-echelon and regime protection units, leaving the aging T-54/55s, the bulk of Syria's tank force facing the Israelis, on the Golan Heights. These older tanks are little match for the Israelis' upgraded M-60 or advanced Merkava tanks. In addition, many of the Syrians'



tanks lack reinforced armor and are vulnerable to Israeli antitank missiles.



ans also lag behind the Israelis in artillary

The Syrians also lag behind the Israelis in artillery capability despite the dramatic rise in the number of artillery pieces acquired by Syria during the past decade. With the exception of multiple rocket launchers, the Syrians have few self-propelled pieces.

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The Syrians adhere to Soviet destrine and rely heavily on massive firepower instead of stressing accuracy. This strategy was evident during the six months of shelling of East Beirut in 1989. Most of the targets hit by the Syrians appeared to be the result of luck and massive shelling rather than skill.

Air Defenses. Damascus relies primarily on its surface-to-air missile network rather than its Air Force for protection of its airspace and has concentrated on building up these defenses since 1982.

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To supplement their surface-to-air missiles, the Syrians have deployed an air surveillance radar network

The network consists of the Tall King, Back Trap, Odd Pair, and Tin Shield air surveillance radars. In addition, the Syrians have deployed the Ramona-M passive detection system, _which allows them to monitor air traffic inside

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Israel, Jordan, and over the eastern Mediterranean. The Syrians have also worked to improve their air defense command and control by incorporating the Soviet-built Senezh and Vektor II semiautomated systems. These systems reduce Syrian dependence on manual command and control systems and should facilitate the flow of information between the air desense units in the area. b3

The variety and quantity of missiles and radars employed by the Syrians reduce the chances that enemy aircraft can successfully penetrate their

airspace on a massive scale.

Air Force. Modernization in the Syrian Air Force has proceeded at a steady pace.

The older MiG-21 fighter makes up about 44 percent of Syria's interceptor force. The more modern and sophisticated MiG-23Gs, MiG-25s, and MiG-29s comprise only 18 percent of this

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force. The Su-20/22 fighter-bombers make up 22 percent of Syria's tactical air capability.

Syrian aircrast and pilots are not as capable

Syria's aircraft lack the sophisticated avionics.

Until the Su-24 is operational — which we believe will be in 1993 — the Syrians will lack the all-weather, day-night,

low-altitude strike capabilities Mos training activity is rigorously scripted and controlled by ground controllers, denying Syrian pilots any initiative.

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Navy. The Syrian Navy's primary responsibility is to defend the Syrian coast, but the Navy demonstrated its ability to deploy outside Syrian coastal waters last year when it blockaded Lebanese Christian ports. Missile boats—OSA-I/IIs and Komars—are the mainstay of the Navy.

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Deterring Tel Aviv

Syria's surface-to-surface missiles and chemical warfare capability are the primary reasons Syria has achieved defensive parity with Israel. Syria has one brigade each of FROGs, Scuds, and SS-21s, totaling 54 launchers. The FROG rocket and Scud missile are inaccurate systems and pose the biggest threat to targets covering large areas such as airlields and population centers. The SS-21 missile provides

Syria with a more accurate short-range system

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The Scud missile armed with a chemical warhead is Damascus's main strategic option. With a 300-kilometer range, Damascus's Scud missiles canb (1) b (3) population centers. Israel's retaliatory options would make Damascus carefully weigh the costs of using this strategic weapon, in our judgment.

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When the Su-24 light bomber is fully integrated into the Air Force in about three years, it could give Syria a more survivable air-dropped chemical weapon delivery platform, magnifying the threat to Israel. The Su-24's 600-to-1,000-kilometer range, depending on the mission's altitude, will allow the Syrians to base the aircraft deeper inside Syria

In addition, the aircraft's avionics
package will provide the Syrians with limited
adverse weather and day-night bombing capabilities
at low-to-medium altitudes

In our judgment, the Syrians prefer missiles to aircraft for delivery of chemical weapons because of the higher probability of reaching the target. To this end, the Syrians have attempted to acquire longer-range missiles over the last five years.

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Outlook

The Syrians will continue to strive for overall military parity over the long term, but the pursuit will be increasingly difficult. We believe they will be able to maintain defensive parity principally because of their deterrent capabilities.

Syrian efforts to reach parity will be further hindered by increased Soviet reluctance to sponsor Syria's strategic goals. The Soviets will undoubtedly continue to stress support for Syria's defensive needs, but they will be reluctant to fully

support its offensive goals. Soviet equipment supply decisions will almost certainly be made with these goals in mind, further frustrating the Syrians. Moreover, Soviet demands for payment of at least some of Damascus's military debt to Moscow will put pressure on Syria's strained economy.



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Lebanon: Who Murdered President Muawad?

President Rene Muawad was killed on 22
November 1989, Lebanese Independence Day, by a ground-level explosion of hundreds of kilograms of plastic explosive. We judge Lebanese Christian strongman Michel Awn was responsible for Muawad's death on the basis of motive, possible gain, and largely circumstantial evidence. Palestine Liberation Organization (PLO) elements or the Iraqi Government may have encouraged or even aided Awn to oppose Syria in Lebanon.

Forensic Considerations

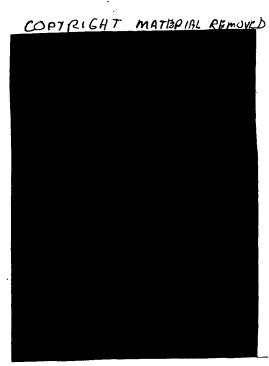
The instrument of Muawad's death was a remotely detonated explosive charge between 200 and 300 kilograms in size. It was hidden in a building along a route Muawad was likely to travel after attending Independence Day celebrations. Reports of the assassination betray no indications of hasty preparation or amateurism, suggesting the device was constructed and emplaced according to a well-conceived and -implemented plan.

Circumstantial Evidence

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unconventional tactics had become part of Awn's repertoire before Muawad's death. In 1988 he orchestrated a provocative campaign of anti-US demonstrations, sit-ins at the US Embassy in East Beirut, and threatened to "take a few Americans hostage." We strongly suspect Awn was responsible for the wave



of bombings that swept East Beirut and the Christian enclave just before the assassination. Some of the bombs exploded outside the homes of Christian delegates who had supported the national reconciliation accord reached in At Ta'if, Saudi Arabia. Since the Lebanese Forces militia supported the At Ta'if accord, it seems unlikely they would have been behind the attacks.

Motive

We believe Muawad's death was engineered primarily to torpedo Lebanese national reconciliation. In addition, the removal of the Syrian-backed President was intended to deal a major blow to Syrian prestige and politically weaken Christians who advocated compromise and accommodation with Lebanon's Muslims. We do not rule out the possibility that Muawad's assassination was also designed to prevent the reconstitution of a central Lebanese national authority. In sum, we believe Awn stood the most





to gain from Muawad's removal. In addition, his death eliminated Awn's main rival for political legitimacy and muted opposition to Awn within the Christian community

Other Suspects

Although Awn is the prime suspect in Muawad's death, other factions in Lebanon could have been responsible:

- The Lebanese Forces militia's opposition to Syria's intrusion into Christian affairs and expertise in carbombing make it suspect. At the time of Muawad's death, however, the Lebanese Forces was supporting the At Ta'if process through its political arm. Even though one should not underestimate the potential of any Lebanese group for treachery, the militia suffered a political setback within the Christian enclave following Muawad's death.
- Iraq is a possible suspect, if only because of Baghdad's persistence in attempting to deliver FROG artillery rockets to the Lebanese Christians last year and the pleasure the Iraqi leadership takes in thwarting Syrian designs in Lebanon.
- The PLO would have an easier time preserving its toehold in southern Lebanon if the central government could not extend its authority there.
- Similarly, the Iranians and radical Shia Hizballah seek to promote disorder in Lebanon as a means of establishing an Islamic republic. Hizballah usually takes credit for its bombings, however, and there has been no claim of responsibility for the Muawad bombing. Although the Iranians may calculate that Muawad's death will promote their interests in Lebanon, revelation of Iranian complicity would jeopardize Tehran's strategically important relationship with Damascus—something Tehran has been unwilling to do. Moreover, there is no direct evidence suggesting an Iranian or Hizballah role.

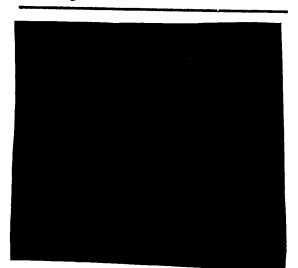
Conclusion

On the basis of motive and possible gain, we believe Michel Awn is the perpetrator.

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The Lebanese National Reconciliation Process

The Saudi-sponsored meeting of members of the -Lebanese parliament in At Ta'if, Saudi Arabia, produced new but fragile hope for the future of Lebanon. After several weeks of wrangling, the legislators reached a compromise - referred to as the At Ta'if accord-that mirrored earlier political compromises that Lebanon's Christians had rejected. The importance of the At Ta'if accord was not its content but the process by which it came about. The fact that representatives of Lebanon's normally fratricidal sects were willing and able to reach a power-sharing agreement indicates that the civil war is not necessarily interminable. If the first step toward political reform is a psychological conversion, then the commitment of Christian legislators to share power with their Muslim counterparts within the framework of a unified Lebanese state could represent the beginning of a new political order. This process represents a formidable challenge to those participants in Lebanese politics who benefit from the continuation of the status quo and the militia system.



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Libya's Deteriorating Economy: Contributing to Domestic Unrest?

Libyan leader Col. Mu'ammar Qadhafi has abandoned the economic reform program he launched in 1988 and appears to be setting the stage for a new round of economic austerity measures. The country's foreign payments situation is deteriorating, as evidenced by a drawdown in foreign exchange reserves. Inflation is on the rise, and the banking sector has been hit particularly hard by capital flight.

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Renewed austerity measures are likely to generate at least some civil unrest, but this probably will not threaten the regime. Qadhafi has weathered other economic crises in his two decades in power and probably knows how far he can squeeze his people before discontent reaches threatening proportions.

Libya's Economic Doldrums

Libya has not recovered from the plunge in oil prices in 1986 that halved its export revenues. In March 1988, confronted by a public weary of economic austerity and humiliated by Libya's military defeat in Chad, Qadhafi removed most restrictions on travel abroad, filled state-run stores with food and consumer goods, and promised private businessmen a much larger role in the production and distribution of goods. These economic steps toward a more market-oriented economy were not fully implemented and did not focus on the serious structural problems plaguing the economy. The poorly planned reforms appear only to have made the situation worse by creating a

serious hard currency shortage, fueling inflation and raising expectations among the Libyan population.

Libya's foreign payments situation deteriorated markedly in 1988. For the first time the trade account moved into deficit because oil revenues — which account for virtually all of Libya's export earnings — fell by 8 percent and imports increased by 4 percent. Compounding this shortfall, Qadhafi's open border policy led to a sharp increase in the services account deficit in 1988.

Libyan tourists in Tunisia and Turkey, which recorded the greatest influx of Libyan visitors—jumped by \$770 million. The poor performances in the trade and services accounts created a current account deficit of \$2.2 billion in 1988, more than double the 1987 shortfall.

Although little data are available for 1989, we believe Libya is still running a high current account desicit. Most important, we believe there was little improvement in the services account desicit because Libyan tourists flush with hard currency and hungry for Egyptian goods slocked to Alexandria after the border with Egypt was reopened last June.

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Despite an increase in oil revenues from \$5.2 billion in 1988 to \$6 billion last year due to higher international prices, Qadhafi probably could not slash import costs—a key goal—in part because international food prices were higher. Libya imports about two-thirds of its food needs. In addition:

The government must pay premium prices for

 The government must pay premium prices for oil-related technology since Washington imposed economic sanctions in 1986.

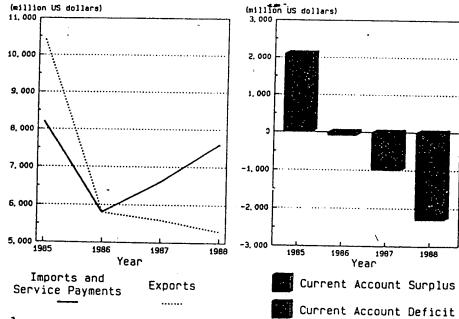
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Libya's Deteriorating Financial Position

A drop in export revenues a and an increase in imports and service payments...

...have pushed the current account into the red.



^a Includes revenues from goods and services.

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The drop in foreign exchange reserves buttresses speculation that Libya's current account deteriorated further in 1989.

Tripoli, for political reasons, does not borrow

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money to finance its current account deficits. Instead, Qadhafi finances the country's foreign payments shortfalls by drawing down foreign exchange reserves.

Capital Flight. Contributing to Libya's financial woes is a flourishing black market that has siphoned off large sums of hard currency from the official banking sector.

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Libyans

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country.

use several ploys to obtain hard currency for

the infractions. For example, Libyans bribe medical officials to obtain certificates indicating expensive medical treatment is required in a third

imports and that Libyan officials choose to ignore

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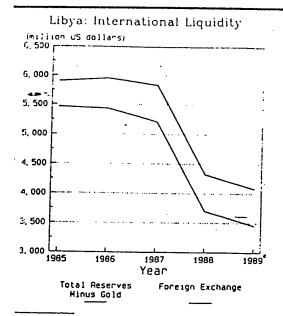
damaging to the Libyan economy.

Libyan markets flourished in Tunisia in 1989 as enterprising Libyans purchased heavily subsidized basic commodities at home, trucked them across the border, and sold them to Tunisians for substantial profits. As a result, shortages of these goods on the Libyan domestic market have increased theft and fueled inflation. Rural areas appear particularly hard hit. The disparity in living standards has become a major bone of contention between Tripoli and the hinterlands.

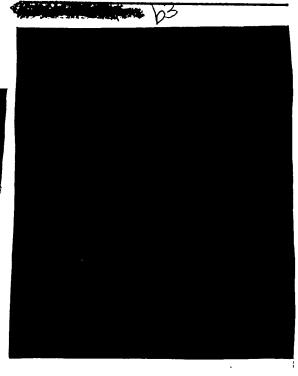
We believe Qadhafi's capricious dealings with foreign trading partners have contributed to domestic shortages.

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2. Libyan-Italian relations have been influenced by the historical legacy of colonial domination and have fluctuated since Qadhali came to power in 1969. The Libyan leader has periodically criticized Rome for atrocities committed during the colonial era and demanded compensation. He has also referred to Rome as Libya's best friend in the Mediterranean. Italy has generally endured Qadhali's sporadic tirades in part to protect its extensive commercial links to Libya.



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Remedial Measures: Will Qadhafi Make the Right Choices?

Qadhafi has taken or is considering several belt-tightening measures.

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Other options under review are similar to those the IMF recommends to troubled countries.

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Three Billion Dollars and Broke?

It is not clear why Libya is in such dire financial straits when it holds \$3.4 billion in foreign exchange reserves. Compared to neighboring Egypt—which has only about \$1.5 billion in foreign exchange reserves and 10 times the number of people—Libya is fairly well off.

times the number of people — Libya is fairly well off.

believe Qadhafi's reserve cushion might be inflated.

Suspicion that

Qadhafi has been lying to Western financial institutions about Libya's financial health.

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Cutting Imports. Qadhafi appears serious this year about cutting the import bill and relying increasingly on barter trade arrangements.

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we believe Qadhafi was preparing the public for a cut in imports during his speech to the Basic People's Congresses in January, when he said "consumer goods are not useful and not necessary."

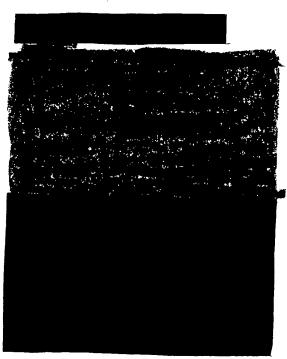
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Outlook for the Economy

Qadhafi probably will have more money at his disposal this year if oil prices remain firm and he successfully cuts imports. Regardless of what he saves from the proposed budget cuts, we believe he will choose to invest his resources in joint ventures, grandiose domestic projects, or support for revolutionary or terrorist groups abroad. In our view, Qadhafi's moves to crack down on private-sector activity will worsen the already serious structural problems within the economy and impede growth. In addition, we expect little improvement in the precarious position of the banking sector and believe European banks doing business with Libya will become more hesitant about providing trade financing or underwriting Libyan projects.

Implications for Domestic Stability

Economic liberalization raised expectations among Libyans that they might once again enjoy the high living standards experienced during the years of high oil prices. We believe Qadhasi's decision to

Setting the Stage for an Economic Crackdown

In a speech to the Basic People's Congresses on 19 January, Qadhafi indicated he believed a return to tighter controls on the economy was needed. The Libyan leader said "everything is tied to oil revenues, and this is grave." How can everything be free, he asked, when the price of oil has fallen? Qadhafi urged the congresses to reconsider Libya's economic system and said they should consider whether Libya should return to "the market system." Qadhafi reminded the congresses that "economic freedom means exploitation, inflation, and unemployment." In addition Qadhafi:

- Blamed the private sector for shortages and inflation.
- Claimed free trade would increase the country's debt. He said free trade ensures the availability of goods, but "at the expense of all the assets and budget of the state."
- Said the people had the authority to determine whether the state should pay for health care and education, but told them "you should see first whether your state has money or not."

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open the borders was a deft political move, but it also exposed his countrymen to the range of consumer goods available abroad and enabled them to experience the personal freedoms accorded citizens in neighboring countries. Strict enforcement of the foreign exchange regulations probably will anger the public, which has been forced to cross the barders to find the most basic consumer goods.

Still, we believe Qadhafi's economic crackdown will not incite a regime-threatening popular uprising. Qadhafi has weathered other economic crises during his 20 years in power. He is a canny political operator who knows how far he can squeeze his people. Only if Qadhafi misjudged the mood of the populace and failed to rescind new austerity measures at the outset of violent unrest would he risk violent and potentially troublesome demonstrations.

Qadhafi may believe that cuts in subsidies could improve the domestic economy. Such cuts would



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eliminate the incentive for trucking Libyan commodities to neighboring countries and could improve the availability of basic goods on the domestic market.

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Kuwait-Egypt: Maturing Bilateral Ties

Kuwait's interest in securing Egyptian stability and its apparent belief that Cairo will once again become a strong moderating force in the Arab world provide the foundation for increasingly close Kuwaiti-Egyptian ties. Kuwait recognizes Egypt's traditionally important role in the Arab world and since independence has worked to expand its political, economic, and security ties to Cairo. The Kuwaitis stepped up security cooperation with Cairo after the Iran-Iraq war threatened to spill over into other Gulf states, and, since the cease-fire, they apparently have looked to Egyptian President Mubarak to discourage Iraqi adventurism in the Gulf.

Foundations of Close Relationship

Both Kuwait and Egypt historically have benefited from their close relations. This relationship originated in Egyptian President Gamal Abd al-Nasir's decision to send Egyptian troops to Kuwait in 1961 as part of an Arab League force to counter Iraqi threats to Kuwaiti sovereignty. After the Arab-Israeli war in 1973, Kuwait supported Egypt and the other Arab belligerents by participating in an OPEC oil embargo against Western countries.

Kuwait severed formal ties to Egypt in 1978 following Cairo's signing of the Camp David accords with Israel

Increased concern over the possible spillover of the Iran-Iraq war led Kuwait to expand military and financial ties to Egypt beginning in 1986 and to reestablish diplomatic relations in 1987.

Since Iran and Iraq announced a cease-fire in August 1988, Kuwait has continued to cultivate close relations with Egypt. The Kuwaitis view friendly ties to Cairo as a counterbalance to the influence of their larger neighbors, Iran, Iraq, and Saudi Arabia. We believe the ruling Al Sabah family has been seeking Egyptian support since last year in the dispute with Iraq over possession of Bubiyan and Warbah Islands, currently under Kuwaiti control. Amir Jabir probably hopes President Mubarak can use Egyptian support to Iraq during the war with Iran and Cairo's affiliation with Baghdad in the Arab Cooperation Council to temper Saddam's pressure on Kuwait. The Al Sabah also may be seeking Egyptian advice on how to respond to rising domestic demand for political reform in Kuwait. Crown Prince Sa'd al-Abdallah Al Sabah during his visit to Cairo in early January publicly announced that the ruling family was seeking a new formula to reconvene the National Assembly.

Far-Reaching Cooperation

On the financial front, Kuwait is lobbying the International Monetary Fund (IMF) to delay its demands for economic reforms in Egypt long enough for Cairo to achieve a measure of financial stability. Kuwait believes IMF-supported reforms would help Egypt over the long term but fears their immediate effect would be to incite political unrest,

Kuwait has been asking Western countries to persuade the IMF to accept slower implementation of reforms rather than insist on strict adherence to measures that Cairo is resisting. Moreover, Kuwait was a leader in securing Gulf state economic assistance for Jordan last summer, and we believe Kuwait would consider similar measures to help boost

1 The Arab Cooperation Council was founded in 1989, and its members are Iraq, Jordan, Egypt, and North Yemen. The aim of this organization is to achieve closer economic integration, but all sides have obtained a short-term political benefit.

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Cairo's foreign exchange position if Egypt's economy declines abruptly.



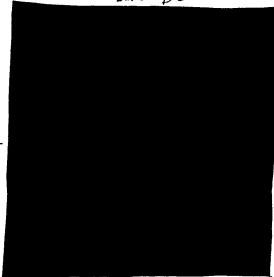
Kuwait and Cairo do not always agree on foreign policy goals

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Outlook

We believe Kuwaiti-Egyptian relations will continue to improve, although more slowly than Egypt would like. Recent visits to Cairo by the Kuwaiti Amir and Prime Minister underscore the importance of the political relationship, even though the talks produced little of substance.

Kuwait is hoping to alter the nature of economic support to Egypt by replacing direct financial grants with private investment. Kuwaiti aid has declined from a peak of about \$400 million in 1986 to less than \$100 million last year and since 1987 has shifted primarily from direct aid to project aid. Kuwait has urged businessmen to consider private investment in Egypt and has worked with Cairo to reduce Egyptian legal constraints to foreign investment. Although some Kuwaiti businessmen may question the low rate of return available in several Egyptian projects, Kuwaiti private investors have channeled an estimated \$3.5 billion since 1962 into Egyptian agricultural, urban real estate, and tourism projects.



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